Group Investing— It's a Whole New Business!

"The main reason to form a group to purchase investment real estate is the ability to pool resources to control properties, not for the generation of real estate fees for the sponsor."

—Gene Trowbridge, JD, CCIM

Gene Trowbridge, JD, CCIM, has been involved in the com-mercial and investment real estate industry since 1975. He operates his own firm, Trowbridge and Associates in Southern California. He has authored live, corre-spondence, and on-line courses for commercial and investment brokers. In 2002, Gene was awarded the Robert L. Ward Instructor of the Year Award from the CCIM Institute. He has been selected several times as "Senior Instructor of the Year" in the CCIM Tax and the Advanced Investment Analysis courses.

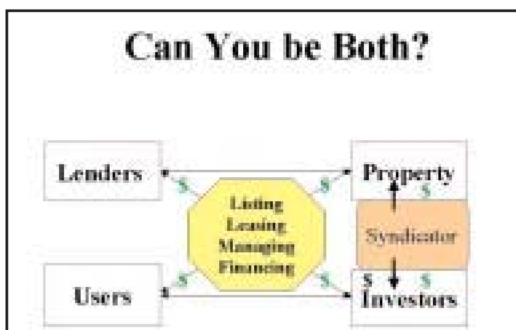
NOTE: In preparation for this article, an electronic survey of SIOR active members was conducted.
Throughout the article, information from the survey is used to emphasize or make a point.

Editors Note: "Members of the Society are reminded that their conduct in 'real estate-related business or professional dealings,' including those in which they are acting as a principal and/or as an agent, are subject to the specific requirements of the Society's Code of Ethical Principles and Standards of Professional Practice. For further information on the obligations of the Code, please go to www.sior.com/governance/documents.html or contact Pamela Fitzgerald at 202-737-1150 pfitzgerald@sior.com."

Why Use Groups?

Many commercial brokers look at group investing as a vehicle to generate traditional real estate fees, such as commissions, leasing fees, and property management fees, but the main reason to form a group to acquire an investment property is the ability to pool resources.

In every real estate cycle, there is a time when obtaining financing is difficult because the supply of loan money is low, when loan money is available but expensive, or when property values have risen to a point where positive cash flows disappear as capitalization rates and yields decrease. In these times, forming a group of investors to pool resources may be the best strategy to acquire a property with a larger equity investment.



How the Sponsoring Broker Benefits

Most brokers focus their daily business activities on matching users, properties, lenders and investors. By positioning themselves in a transaction, the brokers generate income while performing valuable services. But as the sponsor of a group investment, the broker sponsor or "sponsoring broker" positions him or herself between the property and the investors, outside of traditional brokerage activities. The sponsoring broker generates fees from performing various duties required to represent the investors' interests in the property.

Added Risk for the Sponsoring Broker

Forming a group and being the sponsoring broker adds a level of risk to the broker that would not occur if the broker limited his or her activity to traditional brokerage activities. But many broker sponsors appear to be willing to take on the extra risk because it will provide an opportunity to enter a new business that will allow the broker to invest in properties in which he or she would otherwise be unable to invest. The sponsoring broker provides a service to the investors and would be compensated for it.

Agency Relationship vs. Fiduciary Relationship: Are They Compatible?

Transactional brokers primarily operate under an agency relationship with their clients while sponsoring brokers operate under a fiduciary relationship with their investors. It takes in-depth strategic and business planning to allow a broker to perform both agency and fiduciary duties in the same transaction as well as brokerage activities in projects that compete with their investor groups.

Respondents to the SIOR survey commented on mistakes they have made in the past in sponsoring group investments. Interestingly, the most common response related to relationships with the partners, not the perform-ance of the real estate or the agency and fiduciary relationships. Another common mistake related to the sponsoring broker: not setting up the group investment so that there were enough fees to offset the group management responsibility and the sponsoring broker's business risks.

The Syndication Business

n	Property	- Debt	- Investors	= Syndicator
0	(Price)	- (Loan)	- (Units)	= (Risk)
1	CFBT	- ADS	- Cash Dist	= Fees/%s
2				
n			IRR	PV=@ 7%

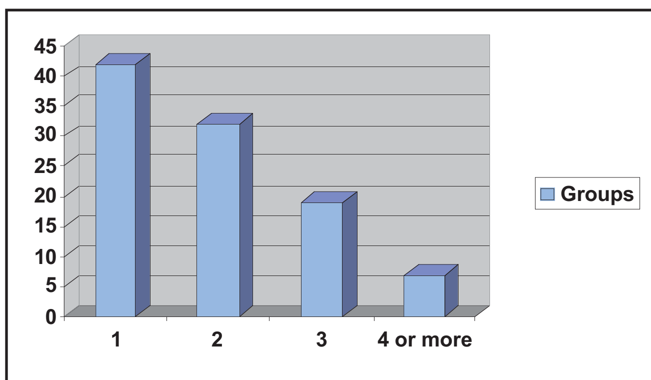
The Risks and Rewards of Group Investment for the Sponsoring Broker—How It Works

As seen below, investment real estate property produces cash flows before tax (CFBT). These cash flows allow for the payment of the annual debt service (ADS) on the loan. When there is a single investor, the investor keeps the remaining cash flow (Cash Dist). However in a group investment the investors agree to pay the sponsoring broker a part of the cash flow from the property in return for the services provided to the group.

Group ownership actually imposes a new layer of costs on a property that would not be present if there were a single owner. There are two results of this extra layer of costs. First, the cash available to be distributed to the investor group is less than available to a single owner. As a result, it is likely that the Internal Rate of Return (IRR) for the investor group is less than it would be for a single owner. For that reason, the properties that will perform in a group investment need to be high yield properties.

Secondly, a sponsoring broker must be willing to take on business risk and receives part of the cash flow in return for the risk assumed. The present value (PV) of cash received by the sponsoring broker must be large enough to compensate for the additional risk.

The reason a broker would act as sponsoring broker and take on a corresponding increase in risk is that the broker can take part in the ownership of properties they could not own on their own and, in addition, the broker can generate fees from being in the business of providing the fiduciary services to the investor group. The broker must analyze whether the rewards outweigh the risks.



SIORs Are Forming Groups

Survey respondents were asked how many groups they were going to form. Approximately 75 percent of the respondents were planning to form one or two groups, with the largest number of respondents planning to form only one group.

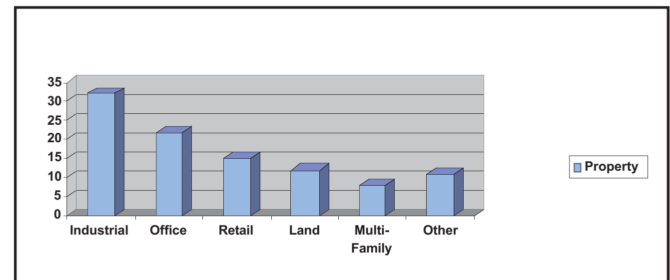
Three Types of Syndications

- Fully Specified
- Semi-specified
- Blind pool

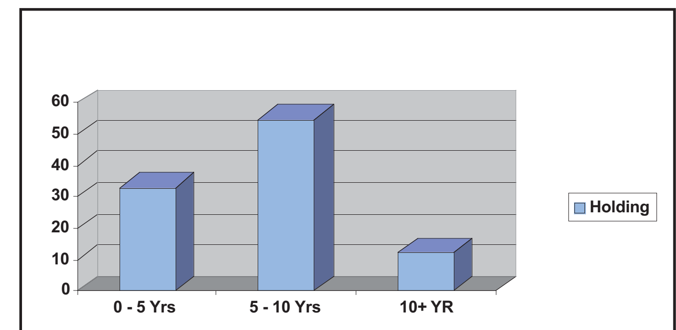
Fully Specified Syndication – Most Common

There are three types of syndication structures. The most common structure is a fully specified offering. A specific property is to be acquired by the group and all the money raised is used in connection with the acquisition and operation of that property. This is considered to be the easiest structure in which to raise money, as the investors knows exactly what they are buying.

Most group investments completed by real estate brokers are fully specified offerings. The graph below shows the type of property SIORs are expecting to acquire through their group investment activity this year. The fact that most investment will be in industrial and office properties is not surprising since SIOR brokers are most experienced in those types of properties. While it is impossible to tell, it may be that the majority of the land being acquired is targeted for industrial and office development.



Respondents were asked to estimate the holding period for the properties they were going to acquire for their investment groups. The majority of the responses indicated an anticipated holding period of more than five years. This reflects the fact that industrial and office properties are typically held for income production over a long holding period. The 30 percent of the respondents who anticipated a holding period of less than five years could be expected to be creating value through development or subdivision and have investors who are looking for a quick return on their investment.



Semi-Specified Syndication – Multiple-Property Potential
Some brokers may be planning a semi-specified offering where one specific property will be acquired, and the group will raise enough funds to purchase one or more additional properties.

Blind Pool Syndication – No Specific Property Target
Only an experienced sponsoring broker should try to operate a blind pool where no specific property is targeted for acquisition. This structure is considered to be the most difficult method of raising money and only sponsoring brokers with successful track records of prior group investments should attempt a blind pool.

Common Legal Entities Brokers Use

- Limited Liability Company
- Limited or General Partnerships

Limited Liability Company (LLC) – Limited Liability for all Parties
The most common legal entities used by sponsoring brokers today are the Limited Liability Company (LLC) and partnerships, either limited or general. While a full discussion of these entities is beyond the scope of this article, a sponsoring broker will likely use an LLC or general partnership when there are a small number of investors. A sponsoring broker may choose to use a Limited Partnership when there are a larger number of investors.

There are two features of the LLC that make it the most popular entity choice today. First, in an LLC, the investors, who are called "Members" may take an active role in the day-to-day management of the property and still have the limited liability offered through a limited partnership. Secondly, the sponsoring broker, called the "Managing Member" has the same limited liability as the other members, as opposed to the unlimited liability faced when acting as a General Partner.

Limited or General Partnerships – More Central Control
When dealing with a large group of investors, allowing each investor to take an active role in management may be cumbersome and the General Partner role available in a limited partnership may be attractive in that it concentrates power more centrally than in the LLC or general partnership. In addition, if the issue of general liability for the General Partner can be resolved through other means, a limited partnership may be attractive. The attorney the broker chooses will give advice as to the best choice of legal entity for the group.

Even though Limited Liability Companies are relatively new entities, 70 percent of the SIOR survey respondents stated that they were going to use a Limited Liability Company for their entity choice; 20 percent of the respondents were evenly split between the limited and general partnership entity.

How Securities Law Relates to LLCs and Partnerships

When a broker forms an investment group, the broker is entering into the world of securities law and must use an attorney familiar with the law. A 1940's court decision established what constitutes a security. Referred to as the "Howey" test, the elements of a security are as follows:

The "Howey" Test:

- Investment of money
- In a common entity
- With the expectation of profits
- From the results of the sponsor's efforts

Brokers enter the world of securities laws when they form a group and raise equity from just one additional investor, take title to the property in a legal entity, such as an LLC, and where the investor expects a profit as a result of the efforts of the sponsoring broker. Every group formed by those responding to the SIOR survey involves security laws and the brokers should know the extent to which they must register their investment group with either the federal or state government, or both.

The Securities and Exchange Com-mission, (SEC) is charged with protecting the investing public. The SEC has determined that they do not have the ability to review every security offering and carved out exemptions from the federal securities law for investment groups formed and operating entirely in one state and for small "private placement" offerings. Securities offered under these exemptions become the responsibility of the State governments.

Two Exemptions from Federal Securities Regulations

- Intrastate Exemption (Rule 147)
- Private Placement Exemptions (Reg. D)

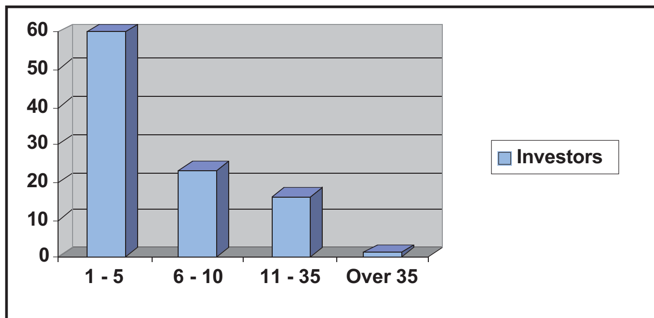
Intastate Exemption
Most brokers will operate under one or both of these two exemptions from full federal securities law registration. The Intrastate Exemption (Rule 147) states that the SEC has no regulatory responsibility if the property, the investors, and the sponsoring broker are all within the same state. Many groups fall under this "intrastate" exemption as the property, the investors, and the sponsor are all in the same state. Federal rules may not apply, but the state securities laws must be followed.

Private Placement Exemption
Most investment groups sponsored by SIORs are intrastate and will also be exempt from registration under the 'Private Placement' exemptions.

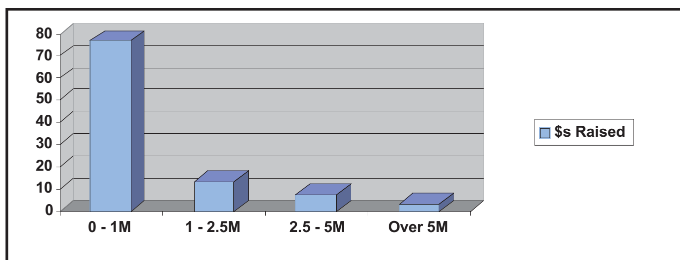
The graph below shows that 60 percent of the survey respondents anticipate having five or fewer investors in their investment groups. Ninety-nine percent of the respondents said that they would have fewer than 35 investors in their group. In addition to the difficulty in managing a group with a large number of investors, there are securities law considerations when planning for a large number of investors in an investment group.

The second exemption to a full securities registration is called the Private Placement Exemption offered under Regulation D (Reg. D) of the SEC rules. This exemption is used in the event that any of the investors, the property, or the sponsoring broker is located in more than one state.

Under Reg. D there are three exemptions available to small

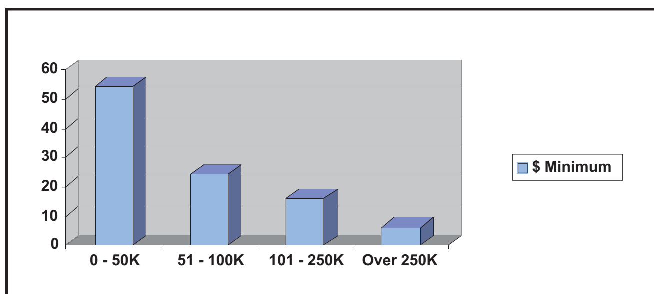


offerings. The most common exemption brokers will use is referred to as the "35-investor rule." The 35-investor rule allows brokers to raise no more than $5,000,000 in equity during a 12-month period and limit the number of investors to 35. There is a prohibition on advertising or public solicitation of investors. The sponsoring broker is required to give each investor a prospectus with adequate information so that they can judge the merits and risks of the investment. The rational behind this exemption is that there is limited need for federal regulation when a small group of investors, presumably known to the sponsoring broker, are provided with adequate information and are invited to form an investment group. This exemption is used in many real estate syndications because $5,000,000 is a substantial amount of equity and the sponsoring broker can raise the funds from as many as 35 unaccredited investors. Many states have adopted this exemption for their own securities rules.



As seen in the above graph, about 75 percent of the survey respondents said that the total equity raised in their investment group would be less than $1,000,000 and very few responded that they would be raising more than $5,000,000.

More than 50% percent of the respondents in the survey indicated that the minimum investment from their investors would be $50,000 or less. Some groups have larger minimums, with several respondents stating that the minimum investment would be greater than $1,000,000.



Looking at the results of the survey in the area of the number of investors in each group and the total amount raised, it shows that most investment groups are formed to comply with the private placement exemption of raising less than $5,000,0000 from fewer than 35 investors.

A second exemption states that, if every investor is qualified as "accredited," there may be an unlimited amount of money raised from an unlimited number of investors. No advertising is allowed and a prospectus is required. State laws may also follow this exemption because the investors are all accredited. Respondents who stated they were raising more than $5,000,000 in an offering may be operating under this exemption. The respondents who stated the minimum investment was $1,000,000 would quickly exceed the $5,000,000 limit and would look to this exemption.

What is an accredited investor? Generally an accredited investor is one who has a net worth in excess of $1,000,000, has annual earnings in excess of $200,000, or can invest more than $150,000 in the investment. These investors are deemed to be of such economic stature (sometimes referred to as "rich" or "smart") that they do not need the protection of the federal government.

The Private Placement Memorandum (PPM)

• Basic Disclosures • Legal Agreement • Subscription Agreement • Offering Questionnaire

The broker is required to provide each investor with a prospectus that contains enough information for the investor to judge the suitability of the investment for their situation. The prospectus contains four major sections and is commonly referred to as the Private Placement Memorandum (PPM). An attorney will prepare most of the PPM.

Basic Disclosures

The basic disclosures section includes a summary of the offering, explains the standards to be used in determining whether the investment is suitable for a particular investor, shows how the money raised will be spent, describes any conflict of interest the sponsoring broker may have, discusses the fiduciary responsibilities of the sponsoring broker, enumerates the potential risks the investment may face, and discloses the track record of the sponsoring broker in previous offerings.

Legal Agreement

In an LLC, the legal agreement is the Operating Agreement. In a limited partnership, the legal agreement is the Limited Partnership Agreement.

Subscription Agreement

A Subscription Agreement is included so that the prospective investor makes an offer to purchase a certain number of units.

Offering Questionaire

The Offering Questionnaire is to be filled out by the prospective investor. It will give the sponsor the ability to determine if the investor meets the suitability standards for the investment.❖

Part 2 Steps to take in forming your group and a sample property-analysis will appear in the Summer 2003 edition.